APPENDIX.

Treasury Department Bulletin

General Counsel's Memorandum 18525

An opinion is requested with respect to the application of Treasury Decision 4633 (C. B. XV-1, 118 (1936), amending the last paragraph of article 191, Regulations 77, applicable to the Revenue Act of 1932, and the last paragraph of article 23(k)-1, Regulations 86, applicable to the Revenue Act of 1934, to read as follows:

> Where banks or other corporations which are subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards) in obedience to the specific orders of such supervisory officers charge off debts in whole or in part, such debts shall be conclusively presumed, for income tax purposes, to be worthless or recoverable only in part, as the case may be, but in order that any amount of the charge-off may be allowed as a deduction for any taxable year it must be shown that the charge-off took place within such taxable year.

The same provision is incorporated in article 23(k)-1, Regulations 94, relating to the Revenue Act of 1936. The pertinent statutory provisions are section 23(j) of the Revenue Act of 1932, section 23(k) of the Revenue Act of 1934, and section 23(k) of the Revenue Act of 1936, which provide for the allowance of——

> * * * *Bad debts.*—Debts ascertained to be worthless and charged off within the taxable year * * *; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

It is to be noted that the language of the statute relating to *partially* worthless debts does not *require* the taxpayer to claim such partial worthlessness as a deduction in any

particular year. It is simply provided that the Commissioner *may* allow as a deduction such partial worthlessness in an amount not in excess of the part *charged off within the taxable year*. Treasury Decision 4633 must, of course, be applied in the light of such controlling statutory provision. Moreover, that decision must be construed in connection with the general regulations governing bad debts. (Article 191 *et seq.* of Regulations 77 and article 23(k)-1 *et seq.* of Regulations 86 and 94.)

Treasury Decision 4633 and related regulations under the Revenue Acts of 1932, 1934, and 1936 establish the following principles applicable in bank cases for the years governed by those Acts:

(*a*) The order of the bank examiner relating to the charge-off in whole or in part of a debt owed to the bank is material only as *establishing conclusively* either total or partial worthlessness of such debt.

(*b*) Where *total worthlessness* of a debt has been so ascertained in any taxable year and the debt charged off the books of the bank in the same year, deduction on account of such ascertainment and charge-off is allowable only for the taxable year in which such ascertainment and charge-off are made. In other words, deduction for total worthlessness so ascertained may be taken only in the taxable year in which occur both ascertainment of total worthlessness and the necessary charge-off.

(*c*) Where *partial* worthlessness of a debt has been so ascertained, such partial worthlessness may be allowed as a deduction in the year of such ascertainment, provided such partial worthlessness is charged off during such year.

(*d*) Where *partial worthlessness* of a debt has been so ascertained but no charge-off made in the year of such ascertainment, no deduction is allowable in the income tax return of the bank for the year of such ascertainment.

(*e*) Where *partial worthlessness* of a debt has been so ascertained in a certain amount in one taxable year *but no charge-off made or deduction allowed therefor in that taxable year*, and during a subsequent taxable year the amount of such partial worthlessness is ascertained in accordance with Treasury Decision 4633 in a greater amount than the amount of such partial worthlessness ascertained during the preceding taxable year, such partial worthlessness may be allowed by the Commissioner in such subsequent taxable year in the greater amount *ascertained and charged off in such later taxable year.*

(*f*) Where such *partial worthlessness* has been so ascertained in a particular taxable year but not charged off or allowed as a deduction for income tax purposes for that year, and *total worthlessness* is ascertained in accordance with Treasury Decision 4633 in a later taxable year and the necessary charge-off of such total worthlessness is made in the later taxable year, deduction for such total worthlessness is allowable for that year.

(*g*) If a debt has been so ascertained to be worthless either in whole or in part in any particular taxable year but has not been allowed as a deduction for income tax purposes in whole or in part as the case may be, amounts subsequently collected on account of such debt are not required to be included in gross income for the taxable year of such receipt (article 191, Regulations 77; article 23(k)-1, Regulations 86 and 94).

(*h*) If a debt has been so ascertained to be partially worthless in a particular taxable year but such partial worthlessness has not been allowed as a deduction for income tax purposes in such taxable year, and the debt is subsequently sold, no adjustment of the basis of the debt should be made in determining gain or loss from such sale. This rule is equally applicable to cases where there has been ascertainment of partial worthlessness but no charge-off

thereof, and to cases where there have been both ascertainment of partial worthlessness and a charge-off, provided no amount has been allowed as a deduction for income tax purposes in either situation.

(*i*) If a debt was so ascertained to be *totally worthless* in 1932 or subsequent years, which are governed by Treasury Decision 4633 or article 23(k)-1, Regulations 94, but no amount has been allowed as a deduction for income tax purposes for the year of such ascertainment, and subsequently the debt is sold, the bank may not deduct any loss based upon the difference between the original basis of such debt and the sale price. It is the opinion of this office that to allow a loss based upon sale under such circumstances in a year subsequent to the year of ascertainment of total worthlessness would permit by indirection the evasion of the statutory provisions requiring deductions based upon claims of total worthlessness of a debt to be taken only in the year of ascertainment of such total worthlessness and charge-off. This rule is equally applicable to cases where the statute of limitations on refunds for the year of ascertainment of worthlessness has run and to cases where such statutory period has not expired. If, however, in any such case the debt is subsequently sold for an amount in excess of the original basis of such debt, it is held that the bank is not taxable on an amount greater than the excess of the proceeds of the sale over such original basis. A tax based upon the entire proceeds of the sale in such case would be of doubtful validity inasmuch as it would be based in substantial part upon an item which is not in reality gain or income. See *Goodrich* v. *Edwards*, 255 U. S., 527; *Koshland* v. *Helvering*, 298 U. S., 441.)

(*j*) Where, in cases governed by the Revenue Acts of 1932 and 1934, a bad debt deduction based upon alleged total worthlessness was disallowed to a bank prior to the promulgation of Treasury Decision 4633 under circum-

stances which would have entitled the bank to such a deduction under the provisions of Treasury Decision 4633, and the statute has now barred a refund for the earlier taxable period, it is the opinion of this office that upon subsequent sale of such debt by the bank no adjustment should be made in the original basis of the debt for the purpose of determining gain or loss from the sale.

It is believed that some of the difficulty in bank cases has arisen from failure to recognize that Treasury Decision 4633 can only operate as a construction or application of a controlling statute, and that it must be read in the light of the statutory provisions which it seeks to interpret in the application of the statute to these specific cases (bank cases). It can not, of course, be taken as setting out substantive rules of law contrary to the plain provisions of the statute. Read in this light, Treasury Decision 4633 can only be taken as setting up a practical rule for *ascertainment* of total or partial worthlessness of debts in bank cases, and not as undertaking to give any effect to such ascertainment which will contravene provisions of the statute or related regulations.

The deductions for bad debts contemplated by the clause "allowed as a deduction for income tax purposes" (as used in (*f*), (*g*), (*h*), and (*i*) above) refer to deductions for bad debts which accomplished a reduction in tax liability and do not refer to deductions for bad debts in cases in which the taxpayer, on account of other allowable deductions, had no net income irrespective of the deduction for bad debts. [Signed by Morrison Shafroth, Chief Counsel, Bureau of Internal Revenue.]

Article 191, Regulations 77

Where banks or other corporations which are subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards) in obedience to the specific orders, or in accordance with the general policy of such supervisory officers, charge off debts

in whole or in part, such debts shall, in the absence of affirmative evidence clearly establishing the contrary, be presumed, for income tax purposes, to be worthless or recoverable only in part, as the case may be.

Article 23 k(1) of Regulation 86 Amending

Article 191 of Regulation 77

> "Where banks or other corporations which are subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards) in obedience to the specific orders of such supervisory officers charge off debts in whole or in part, such debts shall be *conclusively* presumed, for income tax purposes, to be worthless or recoverable only in part, as the case may be, but in order that any amount of the charge-off may be allowed as a deduction for any taxable year it must be shown that the charge-off took place within such taxable year." (Italics ours.)

U. S. Internal Revenue Code—Section 3801 (b)

(b) Circumstances of adjustment.—When a determination under the income tax laws——

> (2) Allows a deduction or credit which was erroneously allowed to the taxpayer for another taxable year or to a related taxyear:

and on the date the determination becomes final, correction of the effect of the error is prevented by the operation (whether before or after May 28, 1938) of any provision of the internal revenue laws other than this section and other than Section 3761 (relating to compromises), then the effect of the error shall be corrected by an adjustment made under this section. Such adjustment shall be made only if there is adopted in the determination a position maintained by the Commissioner (in case the amount of the adjustment would be refunded or credited in the same manner as an overpayment under subsection (c) or by the taxpayer with respect to whom the determination is made (in case the

amount of the adjustment would be assessed and collected in the same manner as a deficiency under subsection (c)), which position is inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition or nonrecognition, as the case may be.

U. S. Internal Revenue Code—Section 3612

(a) Authority of Collector.—If any person fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, wilfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise.

(b) Authority of Commissioner.—In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise——

1. To Make Return.—Make a return, or

2. To Amend Collector's Return.—Amend any return made by a collector or deputy collector.

Section 116. Recovery of bad debts, prior taxes and delinquency amounts.

(a) Exclusion From Income.—Section 22(b) (relating to exclusions from gross income) is amended by adding at the end thereof the following new paragraph:

> "(12) Recovery of bad debts, prior taxes, and delinquency amounts.—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

"(A) Definition of Bad Debt.—The term 'bad debt' means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

"(B) Definition of Prior Tax.—The term 'prior tax' means a tax on account of which a deduction or credit was allowed for a prior taxable year.

"(C) Definition of Delinquency Amount.—The term 'delinquency amount' means an amount paid or accrued on account of which a deduction to or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

"(D) Definition of Recovery Exclusion.—The term 'recovery exclusion', with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under Section 102 or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

"(E) Special Rules in Case of Section 102 Tax and Personal Holding Company Tax.—In the application of subparagraphs (A), (B), (C), and (D) in determining the tax under section 102 or Subchapter A of Chapter 2, a recovery exclusion allowed for the purposes of Chapter 1 shall be allowed for the purpose of such section or subchapter whether or not the bad debt, prior tax, or delinquency amount resulted in a reduction of the section 102 tax or Subchapter A tax for the prior taxable year; and in the case of a bad debt, prior tax, or

delinquency amount not allowable as a deduction or credit for the prior taxable year under Chapter 1 (except section 102) but allowable for the same taxable year under such section or subchapter a recovery exclusion shall be allowable for the purposes of such section or subchapter if such bad debt, prior tax, or delinquency amount did not result in a reduction of the tax under such section 102 or such Subchapter A. As used in this subparagraph references to Chapter 1, section 102, and Subchapter A in the case of taxable years not subject to the Internal Revenue Code, shall be held to be made to corresponding provisions of prior revenue Acts."

(b) EFFECTIVE DATE OF AMENDMENTS UNDER THE INTERNAL REVENUE CODE.—The amendments made by this section shall be applicable with respect to taxable years beginning after December 31, 1938.

(c) UNDER PRIOR REVENUE ACTS.—For the purposes of the Revenue Act of 1938 or any prior revenue Act, the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such revenue Act on the date of its enactment.